

SECOND MONETARY POLICY REPORT
FOR 1984

FROM THE

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS

UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

A REPORT

together with

MINORITY VIEWS

SUBMITTED PURSUANT TO PUBLIC LAW 95-523



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LETTER OF TRANSMITTAL

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC, October 2, 1984.

HON. GEORGE BUSH,
President of the U.S. Senate,
Washington, DC.

DEAR MR. PRESIDENT: Transmitted herewith is the Second Monetary Policy Report for 1984 on the Conduct of Monetary Policy, pursuant to Public Law 95-523 and oversight hearings held on July 25 and 31, 1984.

Sincerely yours,

JAKE GARN, *Chairman.*

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SECOND MONETARY POLICY REPORT FOR 1984

OCTOBER 2 (Legislative day, SEPTEMBER 24), 1984.—Ordered to be printed

Mr. GARN, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

together with

MINORITY VIEWS

[Submitted pursuant to Public Law 95-523]

SECOND MONETARY POLICY REPORT FOR 1984

On July 25, 1984, the Committee on Banking, Housing, and Urban Affairs received the "Midyear Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978" (Public Law 95-523) from the Board of Governors of the Federal Reserve System.

Two days of hearings on the Report and on monetary policy were held by the Committee. On July 25, 1984, Federal Reserve Board Chairman Paul A. Volcker, presented a statement and testimony to the Committee. On July 31, 1984, statements and testimony were received from Beryl Sprinkel, Department of the Treasury, Under Secretary for Monetary Affairs; from William Poole, Member, the President's Council of Economic Advisers; and from a panel consisting of Patrick Savin, vice president, capital markets analyst, Drexel Burnham Lambert Inc. and of A. James Meigs, senior vice president and chief economist, First Interstate Bank of California.

ECONOMIC GROWTH, JOBS, AND INFLATION

Chairman Volcker began the hearings by telling the Committee that:

Measures of aggregate economic activity, employment, costs, and prices have provided an almost unbroken string of favorable news so far in 1984.

Mr. Poole provided the Committee with a statistical table highlighting the strength of the economic expansion. Summarizing the table, Poole told the Committee that:

In this expansion real GNP has grown at a 7.2 percent annual rate compared to 5.9 percent over a comparable period for a typical expansion.

Chairman Volcker emphasized the fact that, in addition to having a strength greater than others, the current expansion's great strength has been longer lasting:

* * * this recovery and expansion period has been atypical—atypical in the sense that such a rapid expansion has been maintained longer after the recession trough than in any comparable cyclical period since World War II, excepting the Korean war episode.

The rapid pace of economic expansion has created jobs at a rapid clip. Chairman Volcker told the Committee that:

Almost 3 million more people have been employed so far this year, bringing the total gains (in employment) over the past 18 months close to 7 million.

Explosive economic growth has been accompanied by continuing progress in the fight against inflation which reached 13.3 percent in 1979 and 12.4 percent in 1980 as measured by the consumer price index. Over the past year, consumer prices have risen only 4.1 percent. They have risen at an annual rate of just 3.4 percent over the last 6 months and at a rate of a mere 2.6 percent over the past 3 months.

Secretary Sprinkel called this progress on inflation "truly remarkable" and noted that:

Since it reached its peak in mid-1980, we have seen the largest decline in CPI inflation in more than three decades.

Mr. Meigs used the superlative: "stunning achievement."

REAL BUSINESS FIXED INVESTMENT

Poole noted that some observers have asserted that this rapid economic growth has been the result of Keynesian-type fiscal stimulus as reflected in large Federal budget deficits, but he told the Committee that this is an incorrect conclusion. Poole told the Committee that the budget deficits have "not been especially important" in explaining the impressive strength of the economic expansion.

Business spending to purchase new factories and equipment has been largely responsible for the strength of the expansion. Over the last six quarters for which data are available, real business fixed investment has increased at a rate more than double its typical contribution to an economic expansion.

In the second quarter of 1984, real business fixed investment as a share of real GNP was higher than for any other quarter since World War II.

Poole stressed that the importance of the investment boom is "insufficiently appreciated":

Private investment spending is important not primarily as a direct stimulus to job creation—jobs can also be created in industries producing consumption goods—but rather as a necessary ingredient to the economic growth process. In the long run the economy cannot grow without more productive capacity. Moreover, the application of new technology from the lab requires that new kinds of capital goods actually be built and placed in service. The end result is growing output, growing labor skills and productivity, and a higher standard of living.

Senator Garn reminded the Committee that the surge in business spending on new factories and equipment was largely attributable to the strong investment incentives provided by the tax cuts in the Economic Recovery Tax Act of 1981.

Mr. Poole agreed with Chairman Garn as to the importance of the tax cuts and told the Committee that they were made particularly effective by the sharp drop in the inflation rate:

The spur to investment from the Economic Recovery Tax Act of 1981 [ERTA] depends importantly on low inflation. The real value of depreciation allowances in the tax law depends on the rate of inflation. * * * It is no accident that in the late 1970's investment tended to flow in directions other than to business fixed investment. With higher inflation the use of original cost depreciation in the tax law made business investment less profitable than it had been in the 1960's. In the late 1970's our investment increasingly went abroad, into land and housing, into precious metals, collectables, et cetera. The combination of lower inflation and ERTA has restored the incentive for business investment.

Secretary Sprinkel emphasized the importance of the reduction in the inflation rate to economic growth and stability:

* * * our efforts to promote economic expansion and stability are likely to be thwarted if basic price stability is not provided * * * the environment of economic growth, lower interest rates and expanding job opportunities that we all seek will not likely be sustained in the absence of reasonable price stability.

Importantly, Poole told the Committee that the outlook for continued low inflation remains bright:

Today's investment boom is a vote of confidence that inflation will remain low in the immediate future.

Mr. Savin agreed:

The apparent message from both hard and soft commodities is that inflation should stay low. * * *

MONETARY GROWTH

Dr. Meigs told the Committee that, under a "standard monetarist analysis," the recent "boom" in economic activity and spending would be explained by the rapid money growth from mid-1982 through mid-1983.

Secretary Sprinkel did not disagree that this would be the "standard monetarist analysis," but he told the Committee that there is growing evidence that the 1982-83 bulge in money growth was merely an offset to the maturing of All Savers Certificates and to the removal of interest rate controls on certain depository-institution liabilities.

Mr. Savin agreed:

(Rapid money growth beginning in mid-1982) caused cynicism to deepen and fears arose that there would be a significant new round of inflation in late 1983 or early 1984. By now we know that was a terribly incorrect forecast. The money spurt, as evidence showed, was not validated by reserve growth and was merely a function of the new definitions of money.

Specifically, the introduction of the money market deposit account [MMDA] and the Super NOW account appears to have resulted in a one-time upward shift in the demand for assets included in the definition of "money." Such an upward shift in the demand for money would be reflected in a one-time downward shift in monetary velocity which would need to be offset by a temporary bulge in money growth.

Monetary velocity merely measures the average number of times a unit of the money supply is spent during some time period. Monetary velocity is the reciprocal of a fraction measuring the percentage of total spending that the general public chooses to hold in assets that are defined as constituting the "money supply."

That fraction apparently increased with the introduction of the popular MMDA and Super NOW. When the fraction increased, its reciprocal—or monetary velocity—declined.

Secretary Sprinkel, furthermore, told the Committee that the downward shift in velocity has ended:

In the last three or four quarters, the behavior of velocity has become more typical * * * velocity appears to be paralleling its historical trend, but along a lower path * * * it is possible that this will turn out to be the ultimate result of recent deregulations: a one-time shift in the level of velocity, after which it will continue to follow a growth path parallel to the growth path projected from historical patterns. If so, the 1982/1983 bulge in money growth can be viewed as an offset to the shift in velocity.* * *

As suggested in the above quote from Secretary Sprinkel, with an end to the downward shift in velocity, money growth needed to slow, and Mr. Meigs told the Committee that:

The slowing of M1 growth since this time last year to about 6.7 percent annual rate through June was a highly desirable development.

Chairman Volcker told the Committee that:

For 1985, the tentative (Federal Open Market Committee) decision was reached to reduce the (target growth) ranges slightly for both M1 and M2, specifically by lowering the top end of the ranges specified for this year by 1 percent and $\frac{1}{2}$ percent respectively. The target range for M3 and the monitoring range for domestic credit were left unchanged.

In summary, the Chairman announced the following "tentative" targets for money growth in 1985:

	<i>Percent change</i>
Aggregate:	
M1.....	4 to 7.
M2.....	6 to 8½.
M3.....	6 to 9.
Debt ¹	8 to 11.

¹ Domestic nonfinancial sector debt.

Secretary Sprinkel told the Committee that the administration supports the Federal Open Market Committee's new targets:

Our best chance of both protecting our gains toward price stability and avoiding any monetary restriction of the economy is for the Federal Reserve to provide moderate money growth. The target ranges announced by Chairman Volcker imply that this is the intended policy of the Federal Reserve. The administration supports this stated policy and strongly recommends that the Federal Reserve take the policy actions needed to assure these results.

Mr. Savin told the Committee that:

* * * it is extremely critical that the Fed continue to slow the growth of money in the environment of 1985 and 1986, helping to reduce the risk premium in interest rates.

Mr. Poole described the new targets as "appropriate," and Mr. Meigs stressed that the Committee:

* * * should support the Federal Reserve in reducing M1 growth by another percentage point in the target for the year ending in fourth quarter 1985.

MONETARY POLICY IMPLEMENTATION

Mr. Meigs, however, criticized the Fed for targeting more than one aggregate and told the Committee that the current system of targeting four aggregates is "tantamount to having no targets."

Meigs summarized a recent study of Japanese monetary policy by John G. Greenwood. The Bank of Japan announces the "expected" growth rate for only one aggregate: M2+CD's. According to Greenwood, "the Bank of Japan has compiled a remarkable record

of never having deviated from its preannounced figure for the expected monetary growth rate by more than one percentage point."

Meigs told the Committee that, in Japan:

* * * lower monetary growth, sustained over several years, has reduced inflation from double-digit rates to less than 2 percent per year. More stable money growth has stabilized economic growth. Japan escaped recession during the two U.S. recessions in 1980 and 1981-82. A more tentative finding of Greenwood's study is that more stable monetary growth also has produced more stable capital markets.

Chairman Garn noted the high degree of uncertainty in U.S. financial markets and suggested that this might be reduced if, immediately after each meeting of the Federal Open Market Committee [FOMC], a summary of the decisions reached were released. Senator Mattingly agreed with the Chairman and said that quicker publication of FOMC decisions might lead to "more efficient decisions regarding employment, savings, investment, production and consumption."

Mr. Poole also agreed:

I think there is good reason to report FOMC decisions promptly. And I mean by that as quickly as practical after the decisions are reached.

Chairman Vocker disagreed and said that immediate release of summaries of FOMC decisions might actually lead to increased uncertainty, for:

* * * if that summary is going to be fair and honest * * * it's going to discuss various contingencies. It's going to discuss various considerations that the committee had in mind, and people will speculate about that and say, "are these contingencies going to come about?"

Chairman Garn responded by stressing the importance of "psychology and perception" to financial markets and by questioning how a simple summary of FOMC decisions could lead to more uncertainty about what had been decided.

BUDGET DEFICITS

Chairman Garn focused on the fact that, while interest rates have declined significantly since 1980 along with the sharp drop in inflation, interest rates still are too high, particularly real interest rates. As one reason, he pointed to Congress's failure "to come to grips with" the Federal budget deficit.

Mr. Poole reiterated the administration's position that "no one disputes the necessity of bringing the budget deficit down over time," but he cautioned that "the emphasis in deficit reduction should be on controlling Federal spending."

Chairman Volcker agreed:

* * * clearly the (Government's) spending is above (its) historical relationship with the GNP; taxes are about as high as they have ever been relative to the GNP. From a

strictly economic point of view, I believe that the more that spending can be reduced to close this gap (between expenditures and taxes), the better.

Mr. Savin told the Committee that:

The notion that Congress can reduce the deficit by raising taxes is a prescription for frustration and disappointment. The cat is chasing its tail. Tax increases raise the probability of economic slowdown, a condition which would generate an even larger deficit. Surely no one would then prescribe a further tax rise.

Mr. Poole also agreed: "Tax increases rolling back the incentives for the private economy to invest and grow would not be constructive."

As evidence that tax increases should not be viewed as a possible way to lower interest rates, Mr. Savin reminded the Committee that interest rates did not react favorably to either the Tax Equity and Fiscal Responsibility Act [TEFRA] of September 1982 or the Deficit Reduction Act of 1984. Moreover, he reminded the Committee that the tax cuts of 1981 were followed by a major bond rally in the summer of 1982.

INTEREST RATES

Mr. Savin warned the Committee not to fall into the trap of blaming all of the interest rate problem on the budget deficit:

As recent experience in both Japan and Germany shows, high budget deficits do not necessarily lead to high interest rates. * * *

Mr. Savin found a parallel between the assertion that budget deficits will derail the economic expansion and earlier assertions that budget deficits would prevent the expansion from beginning:

This committee heard 3 to 4 years ago that the high budget deficit(s)—(which) have been much larger than anyone thought—would keep inflation and interest rates at record levels and would indeed prevent the economic recovery. The problem now is that these same people are saying that the high budget deficit will prevent a sustained recovery. But this is really a canard.

Mr. Meigs warned the Committee against seeking to lower interest rates through faster money growth:

If the monetary authorities use short-run increases in money-growth rates in an attempt to hold interest rates down * * * they risk raising inflation rates (and interest rates) later. That was the mistake made in 1976 and 1977. * * *

Mr. Savin agreed:

As everyone knows tight money—slow money growth—leads to low interest rates and easy money—fast money growth—leads to high interest rates. The difference in outcome lies in both inflation and inflation expectations. Slow

growth in money and ultimately credit leads to low inflation. Risk premiums and interest rates ultimately decline.

Mr. Savin told the Committee that the Fed had fostered uncertainty that has increased the risk premium in interest rates by making "three significant changes" during the last 5 years in the way it conducts monetary policy:

In the fall of 1979, the Fed announced that growth of reserves would become the centerpiece of policy * * * The second major change came in the summer of 1982 (when) the Fed abandoned its (quantity) targets for some months, underwriting a significant spurt in money * * * a third major change in the conduct of policy took place in the fall of 1983. There is reason to believe that behind the shift to contemporaneous reserve requirements the Fed is now using the discount window as a prime focus of strategy with non-borrowed reserves, the bulk of reserves, as the residual.

Secretary Sprinkel told the Committee that:

The current policy approach of the Federal Reserve appears to be focused almost exclusively on targeting emerging real economic activity. The financial markets are completely aware of this. It is for this reason that announcements of economic statistics that imply continued economic expansion often cause interest rates to rise, as market participants expect the Fed to react by "tightening" monetary policy; in this way, "good" economic news becomes "bad" news.

The Secretary also found significant dangers to the economy in conducting monetary policy so as to target a certain rate of economic growth:

(The Federal Reserve's apparent) policy of tailoring monetary policy to contemporaneous real economic developments implies significant potential dangers to the economy. Such a policy approach presumes that the Federal Reserve can foresee all the potential economic and political shocks to the economy, accurately predict their impact, and take offsetting policy actions in a timely fashion. That is a near-impossible task because of the inaccuracy of contemporaneous economic data, and the length and variability of the lags in monetary policy. Thus, a policy of targeting real economic activity subjects the economy to the risks of considerable destabilization as economic developments emerge that are unanticipated or inaccurately forecasted.

The Secretary concluded that:

Preannounced money growth targets that are consistently met become a meaningful policy statement on which the business and investment communities can rely; predictable and prudent monetary trends minimize the uncertainty about future economic performance and inflation and pro-

vide a more stable economic and financial background in which savers and investors can more confidently plan and commit funds.

Mr. Savin told the Committee that a "consistent and clearcut monetary policy is the key to lower interest rates":

The Federal Reserve Board should continue to commit itself to a consistent and clearcut policy which reinforces a tendency to low inflation. Evidence of that commitment would cause the present fearsome risk premium in interest rates to shrink, releasing the bond market from its present torpor and causing interest rates to fall.

TRADE DEFICIT/CURRENT ACCOUNT DEFICIT

In addition to expressing concern over the failure of interest rates to fall further than they have since 1980, members of the Committee expressed concern over the size of the Nation's trade deficit and current account deficit.

Mr. Poole noted that some observers have incorrectly assumed that these deficits are the result of declining U.S. exports. In point of fact, Poole told the Committee, U.S. exports have been rising throughout the economic expansion.

In explaining the causes of the trade and current account deficits, the Fed's "Monetary Policy Report" said:

The exceptional strength of the U.S. economy over the past year and a half has been manifested partly in a surge of import buying. In contrast, the economic recovery in other industrial nations has been substantially less rapid than in the United States, and exports to those nations have lagged. Many developing countries that are burdened with huge external debts have, necessarily, sharply constrained imports, including those from the United States.

Mr. Poole told the Committee that the trade and current account deficits are largely a side effect of dollar appreciation on foreign exchange markets reflecting the improved economic outlook in the United States:

Many analysts have interpreted the decline in net exports as a troublesome aspect of this recovery. While it is certainly true that the rapid growth of imports has produced some dislocations in import-competing industries, the rising capital flow to the United States—the counterpart to the declining net export balance—is a clear sign that investors have tremendous confidence in the U.S. economy. The strong dollar is another sign of this confidence. In short, rates of return and investment opportunities in the United States have improved dramatically over the last 4 years, and the result is an investment boom at home and an inflow of capital from abroad.

Mr. Savin stressed the declining inflation rate in the United States, relative to the outlook abroad, as "the main force behind the rally of the dollar."

The strength of the dollar does not appear to be attributable, in any large measure, to the failure of interest rates to fall as quickly as the inflation rate since 1980; for the dollar has continued to rise on foreign exchange markets as interest rates have continued to decline and as the spread between U.S. rates and those abroad has narrowed.

Reinforcing this point, Mr. Savin told the Committee that lower interest rates in the United States would "keep the dollar strong." This would be because lower interest rates would "move equity prices higher" and

Lower bond yields and higher equity prices would effectively lower the cost of capital, enhancing long-term economic prospects.

Just as Mr. Savin pointed to Japan and Germany as evidence that budget deficits do not necessarily lead to high interest rates, so too did he point to Japan and Germany as evidence that budget deficits do not necessarily lead to trade and current account deficits.

CONCLUSIONS

Pursuant to the requirement in the Full Employment Balanced Growth Act for a report to the Senate by the Committee on Banking, Housing, and Urban Affairs stating its "views and recommendations" regarding the Federal Reserve's Monetary Policy Report, the committee finds:

(1) The decision by the FOMC to lower the upper boundaries of the M1 and M2 target growth ranges for 1985 should lead to a gradual slowing of monetary growth. This appears to be the appropriate monetary policy in light of the continuing need to build confidence in financial markets that the United States will not return to the inflationary policies of the late 1970's.

Success in implementing this policy will require the Federal Reserve to focus primarily on the growth rates of the narrower aggregates in conducting monetary policy.

Interest rates should continue to decline if the Federal Reserve convinces financial markets that the focus of monetary policy is to effect a gradual slowing of these narrower aggregates.

The FOMC should continue to consider releasing a summary of its decisions immediately after each meeting as a way of reducing uncertainty in financial markets.

(2) The trade and current account deficits being experienced by the United States are attributable to three main factors: (a) the strength of the economic expansion which is pulling imports into the United States, (b) the debt problems of certain developing countries that prevent them from buying U.S. exports, and (c) the appreciation of the dollar which makes U.S. exports more expensive abroad and makes imports less expensive here.

The appreciation of the dollar, in turn, is primarily attributable to a flow of capital into the United States. This inflow has continued even as interest rates in the United States have declined and the differential between U.S. rates and those abroad has narrowed. Thus, the capital inflow does not appear to be closely related to

U.S. interest rates or to the Federal budget deficit, as some have alleged.

The principal reason for the appreciation of the dollar appears to be an inflow into the United States of capital seeking to participate in a noninflationary, robust economic expansion.

(3) The administration is correct as to "the necessity of bringing the budget deficit down over time," but tax increases should be used only as a last resort to lower the deficit.

Tax increases that undermined investment incentives would work against continuation of the current boom in real business fixed investment. Reduced spending to build new factories and buy new machines incorporating the latest technology would impair the ability of the U.S. economy to create new jobs, would threaten a resurgence in inflation and would lead to a lower standard of living for all Americans over the long term. More immediately an end to the current investment boom could threaten the entire economic expansion.

All of the witnesses appearing before the Committee during the 2 days of hearings agreed that the budget deficit should be cut through reduction in Federal spending commitments.

MINORITY VIEWS OF MESSRS. PROXMIRE, CRANSTON,
RIEGLE, SARBANES, DODD, DIXON, SASSER, AND LAUTEN-
BERG ON MONETARY POLICY REPORT

The huge budget deficits of the Reagan Administration continue to pose the greatest threat to our prospects for sustained economic growth. These Reagan deficits are keeping interest rates at intolerably high levels, they are depressing the levels of investment in housing and other interest-sensitive industries, they are threatening the survivability of hundreds of thousands of small businesses and farmers, they are contributing to an excessively over-valued dollar, and they are a key factor behind our projected \$130 billion trade deficit which will cost our economy over 3 million jobs.

Unless and until the President of the United States gives top priority to reducing the federal budget deficit, the policy choices of the Federal Reserve will be severely restricted. If it elects to monetize the Reagan deficits in an attempt to hold down interest rates, it runs the risk of sending the economy on another inflationary binge. If it concentrates only on its money growth targets, the unchecked Reagan deficits could drive interest rates through the roof.

Given the limitations imposed on it by the Administration's fiscal policy, we believe the Federal Reserve can only continue to attempt to follow a narrow path between too much and not enough money growth. In the meantime, as we approach the November elections, we are concerned that the Federal Reserve not become a convenient scapegoat for those eager to conceal the fiscal failures of the Reagan Administration. While placing all of the blame on the Fed for all of our economic problems may serve the Administration's purpose, it will not serve the broad purposes of the business and financial communities, whose projections and decisions are undermined by the continuing state of high deficits and economic uncertainty.

For example, the Republican Party platform solemnly declares that the "Federal Reserve Board's destabilizing actions must * * * stop." In fact, the major source of instability in economic policy has come from the fiscal policies pursued by the Reagan Administration. The business and financial communities are clearly concerned over the permanent budget deficits projected over the next several years and the failure of the President to exert meaningful leadership to reduce these deficits. These anxieties are one reason why interest rates still remain so high.

The Republican platform also reflects the views of extremist supply-side economists and their followers in calling for a return to the gold standard. We know of no credible evidence that suggests a return to the gold standard would be workable. If nothing else, it would give the two major suppliers of gold, South Africa and the Soviet Union, a new lever to manipulate and disrupt the free world financial system.

During the 1980 election campaign, we were told it would be possible to slash taxes while vastly expanding defense spending and still balance the budget through the wonders of supply-side economics, or "voodoo economics" as it was termed by Vice-President Bush when he was a Presidential candidate. The policy has been a miserable failure, but we are now told that it can work after all if we only return to the gold standard.

We will not solve our economic problems by indulging in economic quackery. The Reagan deficits are the greatest danger to our economy and we cannot wish them away by following the misguided nostrums of extremist economists whose prescriptions are responsible for much of our current problem. There is no painless way of closing the deficit. Difficult choices must be made, and there is no way those choices can be made without the strong leadership of the President of the United States.

WILLIAM PROXMIRE.
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